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ONLINE SIMULATION FOREGROUND READING

Finance Simulation: M&A in Wine Country
Introduction to Industry & Companies

The U.S. Wine Industry

In 2012 the United States was the world's third largest wine market by unit volume, behind France and Italy, and the largest based on dollar value. Consumption had grown at a compound annual rate of less than 4% over the past decade, and analysts expected annual long-term growth of not more than 3%. Table wine was divided into three segments: basic (jug), popular premium, and super/ultra- premium. Basic represented about 50% of market volume, and consumers tended to buy on price. Popular premium (35%) was purchased based on both price and brand. Super premium was bought based on brand and quality.

Winemaking was capital-intensive: It required land acquisition and vineyard development in addition to large investments in inventory due to lengthy storing and aging requirements. California accounted for over 90% of U.S. production volume, and 75% of U.S. consumption was supplied by domestic wines. Since the mid-1990s, the number of California wineries had doubled to 2,900 and the number of California acres devoted to red wine grapes grew by nearly 90% (acres devoted to white wine grapes grew more slowly). U.S. producers also faced tough competition from imports, which were growing faster than consumption of domestic product.

Several years of favorable weather increased crop yields and produced record grape harvests in California. A global oversupply of wine exacerbated the problem. The "wine glut," combined with economic recession, led to price pressure in the United States from 2001 to 2006. Winemakers resisted lowering retail prices, but some offered discounts to wholesalers, and others started to sell lower-priced brands to consumers. This glut eased after droughts and below-average temperatures caused a large drop in California grape production in 2006. By 2012, the industry seemed to have escaped the oversupply cycle.

Wine typically went from the winery to a wholesaler and then to the retailer. More than 95% of U.S. wine was delivered through the producer-wholesaler-retailer chain. Wholesalers typically handled scores of wine brands. As a result, wine companies with larger brand portfolios and larger volumes enjoyed increased leverage over distributors, and large wineries often established or purchased their own wholesaling companies. Distribution channels were generally becoming more concentrated due to consolidation.

Harvard Business School professors Timothy A. Luehrman and W. Carl Kester prepared this reading to accompany the Finance Simulation: M&A in Wine Country V2 (HBP product #4805). This reading is fictionalized, is not a source of primary data or an illustration of elective or ineffective management and any resemblance to actual persons or entities is coincidental.

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Sales and marketing costs varied widely within the industry. Larger wineries tended to focus more on competing for retail shelf space and spent heavily on advertising and promotion. In contrast, smaller wineries often focused marketing efforts instead at the distributor level. For all producers, direct-to-consumer advertising was becoming increasingly important.

M&A Simulation Context

The U.S. wine industry was fragmented with only a handful of publicly traded companies. The largest publicly traded players in the domestic market were International Beverage and Power Beverages, both diversified beverage manufacturers and distributors, which also participated significantly in the wine business. Their combined share of the U.S. wine market was 31%. Midsize, publicly traded wineries included Bel Vino Corporation, Starshine Vineyards, Bellini Winemakers, and a division of Le Dutrec Enterprises, which together held an additional 6% of the market. The rest of the market was shared by privately held, midsize players and a very large number of small wineries, including the publicly traded Blanc Vin Winery.

Role Descriptions

Role 1: International Beverage Corporation (IB)

International Beverage is a leading, publicly traded international producer and marketer of beverage brands with a broad portfolio across wine, imported beer, and soft drinks. Regarded as an aggressive player in the wine business, the company owned not only vineyards and bottling capacity, but also selected distribution channels in the United States and abroad. The breadth of the company's product lines and its well-developed distribution network are key sources of competitive advantage.

IB's annual net sales are just over $3 billion with a net income of just under $200 million. IB's revenues have grown at an average rate of 10% per year recently, driven largely by an aggressive acquisition-based roll-up strategy. The company buys smaller producers and attempts to create value through cost-cutting, increasing sales via its powerful international distribution network, and exploiting its marketing savvy. The company was well known in the industry as a preferred partner for distributors because of its ability to quickly and efficiently restock wholesalers with product.

IB's organic revenue growth had historically been below 1% per year. Consequently, the company had sought to grow its profits through acquiring scale. Initially, it targeted companies at the low end of the wine-quality spectrum; more recently, it became interested in higher-end wine properties, particularly in the faster-growing premium and fine wine segments. However, in 2012, the company's product portfolio was still skewed toward lower-priced wines.

Although IB's management team was considered strong, some Wall Street analysts had been critical of the company's roll-up strategy, believing that it had not generated enough value for shareholders and that IB overpaid for some of its acquisitions. The prices paid for recent targets, given their near-term cash flow generation, required a long-term profit-growth rate in excess of what IB management had so far delivered. International Beverage's management team was well aware of the increased scrutiny from shareholders that future acquisitions would likely receive.

Role 2: Bel Vino Corporation (BV)

Bel Vino Corporation is a high-end California winery widely credited with having put California on the map as a world-class wine producer. Bel Vino is known for its classic vintages and strong brands, including the highly coveted Uva del Sol brand. Recently the company's annual sales, just over $370 million, have lagged behind its competitors'. Bel Vino has so far been unable to secure satisfactory relationships with international distributors (less than 10% of revenues are generated abroad), and with heightened competition in U.S. channels, the company had difficulty growing revenues in line with analysts' expectations. In 2012 management is concerned that its status as a leader and innovator could be threatened by insufficient cash flow for investment in technology.

There were other distribution problems as well. National distributors in the United States had begun squeezing out regional players with whom Bel Vino had strong historical relationships. Consequently, Bel Vino found itself forced to compete with small and midsize vintners for attention from national distributors. The company had so far resisted spending on national consumer advertising, which it regarded as wasteful, given that its wines were sold mostly in a limited number of targeted regions. Industry analysts expressed doubts about whether Bel Vino was well positioned to compete in the emerging environment, which was likely to be dominated by a few national distributors.

Bel Vino, which is publicly traded, was rumored to be a takeover target because of its combination of sluggish performance, strong brands, and prized vineyard properties. The company also was known to be coping with conflict in the senior management ranks, largely comprising family members who were descendants of Bruno Morelli, the company's legendary founder. For its part, management was increasingly frustrated with Wall Street's preoccupation with high-volume wines while lower-volume specialty labels, such as Uva del Sol, were undervalued despite their prestige and reliable sales. The Morelli family, which still owned 24% of Bel Vino's shares, viewed the long-term protection of the company's prestigious brands, which required continuous patient investment, as paramount among their management responsibilities. Others believed that the company should limit investment in the premium business and instead leverage the Bel Vino name by aggressively entering the larger mid-range, "lifestyle" wine segment.

Even critical Wall Street analysts were quick to praise Bel Vino's CFO and his unflagging efforts to instill financial discipline in the firm. There were careful controls on costs, and Bel Vino's were among the lowest in the industry for its size. Bel Vino's managers were very strong in negotiating favorable grape-acquisition contracts and managing overall production costs, resulting in lower COGS relative to most competitors of its size. Finally, careful attention to SG&A made Bel Vino one of the most reliably profitable producers in the industry, despite its slow growth.

Role 3: Starshine Vineyards (SS)

Starshine Vineyards is a midsize, publicly traded wine producer with annual revenues of approximately $525 million. A decade earlier the company had decided to move down-market and acquired a few mid-range labels. Some in the industry criticized this strategy, believing that the company had lost its strategic focus and pointing out that although price segments enabled Starshine to develop a successful network of national distributors. Despite having secured these distribution relationships, Starshine faced increasing pressure from low-cost imports from newer producers in South Africa, Latin America, Australia, and elsewhere. Most such producers lacked the caché and established brands of other exporters but enjoyed very low land and grape costs. They had been successful recently at claiming significant market share in the mid-range and lower-priced segments of the U.S. market.

Although it enjoyed excellent distribution, Starshine Vineyards was not regarded by Wall Street as particularly well run. A common criticism was inattention to cost control especially in the sales and marketing area, which funded large national ad campaigns for Starshine's flagship Woodlands label. The company's marketing executives were widely regarded as market-savvy and creative, even if not sufficiently cost-conscious; they were credited with numerous marketing innovations — including networking, promotional events, and wine shows — that were widely adopted by other companies. Finally, Starshine also had recently formed joint-venture partnerships with two international wine producers. The JVs were being closely watched; many observers expected them to succeed and to set a pattern for other producers.

The Financial Forecasts

The financial forecasts that have been provided to you represent a compilation of historical performance data from Bel Vino, Starshine, and International Beverage. They have been enhanced with mean forecast data from the various stock analysts that cover the firms, as well as with data from several different potential valuation tools.

Other Industry Players

Power Beverage

Power Beverage is an international brewer, bottler, and marketer of beer and soft drinks with over $6 billion in annual revenues (60% from beer and 40% from soft drinks). Based in the United States, it is the sixth-largest brewer in the world. As consumer tastes changed in the 1970s, Power Beverage started experimenting with light beer products that proved very successful. About 40% of Power Beverage's beer revenues are generated by international sales. Power Beverage's soft drinks business is less than 20 years old and consists primarily of a line of lower-end, branded carbonated lemonade and orange soda drinks sold almost entirely in the United States. PBC also supplies private-label soda to supermarket chains in the Midwest.

Selected Power Beverage Financial Data

2011 Sales (millions)	$6,190
1-Year Sales Growth	5.9%
2011 Net Income (millions)	$497
1-Year Net Income Growth	37.7%

Bellini Winemakers

Bellini Winemakers is a northern California winemaker founded in the 1970s. Revenues are approximately $500 million with $25 million in net income. Bellini produces premium "lifestyle" table wines that are top sellers. Its wines are available through many premium retail channels including fine restaurants, hotels, specialty shops, supermarkets, and club stores. In response to the difficult business condition in the wine industry since 2003, Bellini has reduced headcount and sold some non-core business interests. It has sought new revenue opportunities by developing a luxury wine brand in partnership with a French vintner.

Blanc Vin Winery

Founded in 1880, Blanc Vin is an Oregon winery specializing in super-premium, high-end varietal wines and sparkling wine (60% of revenues). During the 1990s it began importing premium wines from Italy and Chile and created a high-end wine brand in France. It has established special marketing arrangements for its sparkling wine with national event planning organizations. Its wines are sold in the Pacific Northwest through its Connoisseur Fine Wines distribution operation, and via other distributors and brokers throughout most of the United States. Blanc Vin also sells wine directly to consumers at its winery. The company's sales are only $25 million, but its annual revenue growth rate has exceeded 25% over the last 5 years. Net income has been approximately $5 million per year and has grown by 30% annually. It's a microcap stock that started trading on NASDAQ in 2011 and that has just received analyst coverage.

Le Dutrec Enterprises

Le Dutrec Enterprises (LDE) is a leading, Paris-based luxury-goods manufacturer and retailer whose brands are regarded as desirable by wealthy consumers worldwide. LDE is a quite diversified company, with over $20 billion in annual revenues and sales growth over 23% per year. Of its revenues, 20% come from an upscale Paris department store chain, 30% from fashion clothing and expensive leather luggage, and another 30% from cosmetics and perfumes. LDE's foray into the wine business is more recent and constitutes the remaining 20% of revenues. The company produces super-premium table wines, French champagne, and fine spirits, including cognac and port. In the United States, it has a deliberately limited distribution network, intended to enhance the prestigious image of its wines, which are available primarily at luxury hotels, restaurants, and exclusive retailer.